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Hungary:
Economic policy turn ahead?

The Hungarian economy will slide into recession this year due to the austerity measures required to reduce the fiscal deficit to below 3% of the GDP. Further, but smaller consolidation measures will be necessary in 2013 as well. An agreement with the IMF and the EU may help partially restore confidence in the government's economic policy; nevertheless, that would also mean the end of the 'unconventional' policy measures and probably a revision of some of the earlier introduced ones, such as the radical tax cuts. In the absence of an agreement with IMF and EU, the consequences may include a remarkable weakening of the exchange rate and serious difficulties in rolling over external debt.

In mid-November 2011 the Hungarian government announced that it would turn to the IMF and the EU for assistance. Why does Hungary need a new agreement with the IMF and the EU? While the Hungarian economy without doubt struggles with serious problems, its general condition in early 2012 is much better than it was in the critical days of October 2008, when the country turned to the IMF-EU tandem last time. Foreign currency reserves are now more than twice as high as then, the current account balance is in surplus and banks have sufficient liquidity. The reason is that one and a half years after its landslide election victory, Prime Minister Victor Orbán and his 'unconventional' economic policy, a centrepiece of Mr. Orbán's political credo, face a massive loss of confidence in the international community.

Confining the issues discussed here to those of economic relevance, the list of troubles begins with the increasing confrontation with the European Union. Some laws adopted in the legislative rush of the last months of 2011 have been found by experts of the Commission to be in conflict with EU law. These include the flat personal income tax and the status of the central bank – laws where amendment needs a 2/3 majority. The PM's claim to tie in this way the hands of the next governments over more legislative periods ahead was not welcome by the EU. The second front in the EU-Hungary confrontation is that of the budget. Hungary has been under the Excessive Deficit Procedure since its entry to the EU, the longest time for any EU member. Though Hungary's general government deficit will remain, even in the judgement of the Commission, below 3% of the GDP this year, the Commission is of the (justified) opinion that Hungary's fiscal stance is not sustainable in the medium term. The required maximum 3% GDP proportional deficit cannot be observed in 2013 without fiscal adjustments. This opinion of the Commission may have grave consequences: in the absence of further fiscal consolidation Hungary may lose one third of the transfers from the Cohesion Fund of the Community budget. In money terms, that equals a loss of nearly EUR 500 million between 2013 and 2015. The third frontline is the EU's new 'six pack' governance package. In the first 'Alert Mechanism Report' Hungary was placed in the group of member states where an in-depth analysis of the economic situation has been initiated by the Commission to investigate imbalances and emerging risks. Of Hungary's peers in the region, only Slovenia and Bulgaria are in this group.

Apart from the confrontation with the EU, Hungary has repeatedly received critical remarks from the US. Although this criticism is predominantly focused on the dismantling of western-style democracy in Hungary, the economic consequences that may appear during the forthcoming negotiations with the IMF are not negligible. Hungary's position in the global arena has deteriorated as well. In January 2011 also Fitch Ratings, the last of the three leading credit rating agencies where Hungary had still been in the investment category, downgraded Hungary's sovereign debt to junk.

The above-described worsening of Hungary's international position went hand in hand with a deterioration of important economic indicators. The exchange rate of the forint had been weakening continuously since the summer of 2011 with a sudden breakdown in early January, when the HUF/EUR rate surpassed the weakest quotation of the forint during the climax of the crisis in early 2009. Despite the relaxation experienced since then, the exchange rate has remained weak and volatile. By the end of 2011 Hungary's CDS spreads ranged between 600 and 700 basis points, also surpassing the values recorded in the worst days in 2009. Moreover, while in 2009 Hungary moved in unison with its peers in the region, this time there is a huge and growing difference compared to those countries. Finally, Hungary's sovereign foreign currency bond spreads rose from 250 basis points in April 2011 to close to 900 basis points by the end of last year. It is important to mention here that positive expectations of the markets concerning the outcome of the (not yet started) negotiations between the government and the IMF/EU improved both the CDS spreads and the bond yields in February. The exchange rate depreciation, the high CDS spreads and bond yields, and the slowdown of FDI inflow indicate clearly a crisis of confidence. Even if an unambiguous causality cannot be proved, the political attitude of the Orbán government may be the main factor behind the weakened confidence. Major elements of this attitude are the confrontational course of the government with the EU at various junctures, the chasing away of and the return to the IMF, hostile rhetoric towards banks and towards foreign ownership more generally (though not in manufacturing sectors), retroactive taxes, lack of dialogue with social partners, unpredictability and, last but not least, the generally perceived weakened rule of law. The government claims, to some extent with good reasons, that what it really needs from the IMF and the EU is not financial assistance but a sort of insurance that Hungary is 'OK' and international investors have no reason not to trust this government. The problem is that neither the IMF nor the EU will be ready to underwrite this as long as they are not convinced that Hungary is on the way back to sustainable fiscal policy and accepts classic values of a western-type market economy and democracy. Whether the Orbán government will be ready to accept this (or will eventually be unable not to comply) is currently (early March 2012) an open question. An agreement (with all the typical conditionalities) may help to restore confidence in Hungary relatively soon. Should the negotiations collapse (or even not be started in the first place) the negative phenomena recorded in the second half of 2011 and in early 2012 may reappear and lead to a drying-out of the market for Hungarian government securities, or the interest to be paid remains so high that a lasting market-based financing of the debt rollover results in an unsustainable increase of public debt. In the latter case, an accelerating negative spiral may lead to Hungary's insolvency. In that scenario a return to the negotiation table with the IMF and the EU is again an option. The other option is the uncontrolled default.

This gloomy picture is, however, not in strict accord with that revealed by macroeconomic data. In 2011 GDP expanded by 1.7%, a relatively good performance in the EU-27. The only contribution to economic growth may have come from net exports. Private consumption, after declining three years in a row, may have stagnated last year. In gross fixed capital formation the trend is improving, but even that means only a slower, yet significant, pace of contraction compared to the previous two years. Some contribution to growth came from industry, where the rate of expansion was nevertheless only half of that in 2010. Contrary to the weak performance in 2009 and 2010, agriculture had an exceptionally good year in 2011. As the GDP data reveal, the only real success story is that of foreign trade. The increase in exports was in the double-digit range and substantially higher than that of imports. The current account balance, which had undergone a trend reversal in 2008/2009 (from -7.3% to -0.2% of the GDP), was positive in 2011, when it may have amounted to 2% or even more of the GDP.

Slowed down financial intermediation is a major concern. Lending to the private sector, expanding by about 20% annually before 2008, turned negative in 2009 and the contraction gained momentum in 2011 (4%). While stagnating consumption and falling investment may have been the reason for the decline in credits from the demand side, the causality may easily be reversed: expensive credits coupled with a very conservative lending policy can be seen behind the decline of financial intermediation as well. A definitive explanation of the phenomenon is related to the difficulties the banks have to cope with. The extremely high levy charged on the financial institutions totalled HUF 140 billion (0.5% of GDP) in 2011. Additionally, last year the government launched a campaign for early repayment of foreign exchange (mainly CHF) denominated mortgage loans. Debtors were invited to pay back their loans at a preferential fixed exchange rate. The difference between the market and the fixed exchange rate had to be covered by the banks. According to various estimations, 900,000 to one million contracts were potentially involved, of which about 20% may have actually participated in the early repayment scheme. (That means that FX mortgage loans, amounting to about 15-16% of the GDP even after the completion of the early repayment scheme, remain a major concern.) The loss on the early repayment scheme amounted to HUF 200-300 billion (0.7% to 1% of GDP). The share of non-performing loans rose from 8.5% in 2009 to 12.5% in 2010 and 14.5% in 2011.

Fiscal consolidation has been an issue of outstanding importance since 2006. By 2009 the general government deficit was reduced, in three distinct waves, from over 10% to 4.5% by the second Gyurcsány and the Bajnai governments. The second and third waves of fiscal consolidation took place already under the auspices of the IMF/EU agreement. The pains related to the waves of fiscal consolidation are among the main explanatory factors behind the landslide election victory of the Fidesz party in 2010. Fidesz considered the fiscal consolidation oriented economic policy of the socialist-liberal and later of the technical government completely wrong and propagated an alternative economic policy without any painful restrictions. After the election victory the new Fidesz government started with measures to stimulate the expansion of the economy in the hope of ‘growing out’ of the fiscal deficit and public debt. These included a radical tax reduction programme (first of all the personal income tax and corporate tax were reduced). As it became clear that the EU would not tolerate a fiscal defcit substantially higher than 3% – which would have been the initial price for the planned new growth path of the economy – the government started to improvise measures in order to fill the gaps opening up on the revenue side of the budget. First the levy on financial institutions was introduced, followed by sector-specific taxes for the large, predominantly foreign-owned companies in the telecommunications, energy and retail sectors. The assets of the mandatory second-pillar pension funds were nationalized, with the largest part of these revenues allocated to reducing public debt and with a smaller one financing the 2011 budget.

But economic growth has not taken off. One year after its inauguration the government made an economic policy half-turn and announced that the fight against public debt would be the new focus of its efforts. It adopted a detailed programme (Széll Kálmán Plan) including measures aimed at attaining a deficit of less than 3% (relative to GDP) by 2012. The seemingly good fiscal stance in 2011 disguises the challenges to be faced. The 2011 fiscal surplus (about 3.5% of GDP) was achieved through accounting of the revenues from the nationalization of the pension fund assets in that single year and conceals the fact that actually a considerable fiscal loosening occurred last year. Cleared from the pension funds effect, the fiscal balance would show a deficit of about 5.5% of GDP. That means that part of the fiscal consolidation achieved in 2008-2009 has been lost last year. Though the European Commission and the majority of observers including the wiiw assume that Hungary's fiscal deficit will be around 3% of the GDP in 2012, securing this result requires considerable additional efforts. This year the fiscal tightening compared to 2011 may amount to 2-3% of the GDP, and may necessitate extraordinary interventions over the year. The really difficult year, however, will be 2013, when all sector-specific taxes and half of the bank levy will be phased out, and it is difficult to see what will replace these revenue elements.

The uncertainties around the forecast for 2012 and 2013 are much larger than they usually are. Our baseline scenario assumes an agreement with the IMF and the EU and a partial restoration of confidence. This will not help economic growth in the short run, and in fact wiiw predicts a recession in the range of zero growth to 2% decline. This is due to declining consumption and investment caused by the required austerity measures. Again net exports alone will somewhat counterbalance other, contracting components of the GDP. For 2013 a moderate expansion of the economy is projected: consumption will still stagnate, but a (hoped-for) restoration of confidence will allow for an upturn of investment activities and that will be supplemented by the positive contribution of net exports to the GDP. Nevertheless, the deteriorating growth outlook in the eurozone may slow down the expansion of Hungarian exports. Finally, a possible agreement with the IMF and the EU, and the conditionalities attached, will seriously affect the development of the Hungarian economy in the short and medium run.

Table HU

Hungary: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011 [1]	2012	2013 Forecast	2014
Population, th pers., average	10071	10056	10038	10023	10000	9960	9940	9920	9900
Gross domestic product, HUF bn, nom.	23675.9	24991.8	26545.6	25622.9	26747.7	28150	29100	30500	32100
annual change in % (real)	3.9	0.2	0.9	-6.8	1.3	1.7	-1	2	3
GDP/capita (EUR at exchange rate)	8900	9900	10500	9100	9700	10100	.	.	.
GDP/capita (EUR at PPP)	14900	15400	16000	15200	15800	16400	.	.	.
Consumption of households, HUF bn, nom.	12369.8	13363.6	13985.5	13568.3	13854.2	14300	.	.	.
annual change in % (real)	2.0	1.0	-0.5	-6.4	-2.1	0	-1.5	0	2
Gross fixed capital form., HUF bn, nom.	5148.0	5444.2	5760.0	5295.2	4806.3	4750	.	.	.
annual change in % (real)	-2.7	3.8	2.9	-11.0	-9.7	-4.5	-1	2	3
Gross industrial production									
annual change in % (real)	9.9	7.9	-0.2	-17.6	10.5	5.4	3	4	8
Gross agricultural production (EAA)									
annual change in % (real)	-3.0	-12.5	27.7	-10.3	-11.5	9.4	.	.	.
Construction industry									
annual change in % (real)	-0.7	-14.0	-5.2	-4.4	-10.4	-7.7	0	5	8
Employed persons - LFS, th, average	3930.0	3926.2	3879.4	3781.8	3781.2	3811.9	3810	3830	3850
annual change in %	0.7	-0.1	-1.2	-2.5	0.0	0.8	0	0.5	0.5
Unemployed persons - LFS, th, average	316.7	312.0	329.1	420.7	474.8	467.9	.	.	.
Unemployment rate - LFS, in %, average	7.5	7.4	7.8	10.0	11.2	10.9	11	10.5	10
Reg. unemployment rate, in %, end of period	9.1	10.1	10.9	13.6	13.3	12.5	.	.	.
Average gross monthly wages, HUF [2]	171351	185018	198741	199837	202525	213054	.	.	.
annual change in % (real, net)	3.6	-4.6	0.8	-2.3	1.8	2.4	.	.	.
Consumer prices (HICP), % p.a.	4.0	7.9	6.0	4.0	4.7	3.9	5	3.5	3.1
Producer prices in industry, % p.a.	6.6	0.3	4.6	4.5	6.3	2.5	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	42.7	45.6	45.5	46.9	45.2	52.0	.	.	.
Expenditures	52.1	50.6	49.2	51.4	49.5	48.5	.	.	.
Net lending (+) / net borrowing (-)	-9.4	-5.1	-3.7	-4.5	-4.3	3.5 [3]	-3	-3	-3
Public debt, EU-def., in % of GDP	65.9	67.0	72.9	79.7	81.3	80.3	81	80	79
Central bank policy rate, % p.a., end of period [4]	8.00	7.50	10.00	6.25	5.75	7.00	.	.	.
Current account, EUR mn	-6634	-7224	-7728	-153	1061	2000	2200	1800	1100
Current account in % of GDP	-7.4	-7.3	-7.3	-0.2	1.1	2.0	2.2	1.7	1.0
Exports of goods, BOP, EUR mn	58378	67811	72043	57397	68964	79300	85600	95000	105500
annual growth rate in %	17.5	16.2	6.2	-20.3	20.2	15	8	11	11
Imports of goods, BOP, EUR mn	60840	68500	73233	55028	65735	74600	80200	87800	97000
annual growth rate in %	16.5	12.6	6.9	-24.9	19.5	13.5	7.5	9.5	10.5
Exports of services, BOP, EUR mn	10876	12574	13804	13305	14642	15370	16000	17600	19400
annual growth rate in %	5.1	15.6	9.8	-3.6	10.0	5	4	10	10
Imports of services, BOP, EUR mn	9447	11231	12287	11319	11735	12320	12800	13800	14900
annual growth rate in %	3.4	18.9	9.4	-7.9	3.7	5	4	8	8
FDI inflow, EUR mn	5468	2861	4225	1140	1363	-1000	.	.	.
FDI outflow, EUR mn	3118	2646	1503	1321	942	400	.	.	.
Gross reserves of NB, excl. gold, EUR mn	16384	16305	23807	30648	33667	37655	.	.	.
Gross external debt, EUR mn	86681	103988	123454	136879	137602	139000	.	.	.
Gross external debt in % of GDP	96.8	104.6	117.0	149.8	141.7	137.9	.	.	.
Average exchange rate HUF/EUR	264.26	251.35	251.51	280.33	275.48	279.37	295	290	285
Purchasing power parity HUF/EUR	157.79	161.74	165.55	168.29	169.20	172.32	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary and wiiw estimates. - 2) Enterprises with 5 and more employees. - 3) Including the one-off effect of nationalisation of the private pension funds' assets. Without that effect general government buget balance is forecast to attain -5.5% of the GDP. - 4) Base rate (two-week NB bill).

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.